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Ontario's Green Energy "Fee": The Trouble with Taxation through Regulation

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- Canadian provincial governments have broad authority to impose direct taxes by passing enabling legislation in their respective legislatures.
- Governments may also use regulation to set fees, for example, to recover the cost of services they provide, but cannot use regulation to impose taxes that raise general revenue. Doing so would be unconstitutional.
- Governments nonetheless sometimes attempt to raise revenue by imposing levies that are deliberately mislabelled as "fees" – past efforts to do so have exposed provincial governments to successful constitutional challenges.
- This *e-brief* examines problematic example: the Ontario government recently ordered the Ontario Energy Board to impose a "fee" to be used to fund activities of the Ministry of Energy and Infrastructure; this fee is quite likely an unconstitutional tax.

Background

Canada's constitution and the case law that surrounds it define the relative jurisdiction and powers of the federal government and the provinces. In matters of taxation, government authority is extensive, and legislatures may enact laws imposing a wide range of taxes. However, governments are more limited in what they may do without gaining legislative approval. They may use regulation, which is not approved by a legislature, to set fees to recover the costs of goods or services they provide to the people being charged the fee. They may not, however, use regulation to impose taxes that fund the general activities of government. Taxes require legislative approval.

Provincial governments have often sought to raise revenue quietly through regulation. The reasons vary, but include a desire to avoid political embarrassment in the legislature or to steer around, for example, prior legislation requiring a referendum before any new tax might be imposed. There are two examples of regulatory fees being imposed quietly, and for the purpose of raising general tax revenue: for many years New Brunswick imposed liquor sales charges on bars and nightclubs through regulation; and Ontario long collected a fee equal to a fraction of the value of testamentary estates through "probate fees" through regulation; these practices exposed those governments to successful constitutional challenges.

The attraction for governments of quiet regulation as opposed to newly legislated tax measures is understandable. In Ontario, legislation is in place that seeks to make new taxes embarrassing to the government. *Ontario's Taxpayer Protection Act* 1999,[1] section 2, requires a referendum approving a tax

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1 *Taxpayer Protection Act* 1999, S.O. 1999 c. 7.

increase or a new tax before any bill proposing a tax increase or new tax is introduced. While this kind of legislation can be overridden by subsequent enactments of the legislature (and Ontario has done this by amending section 2 of the *Taxpayer Protection Act* 1999 in 2002 and 2004), the process increases the political costs to governments that raise taxes.[2]

Governments' temptation to quietly impose taxes is clear enough – so too is the need to resist such attempts as they arise. If provincial residents acquiesce to taxation by regulation, Canadians will ultimately have less protection from arbitrary government action.

The Case of the Green Energy Levy

By a recent Order-in-Council, the Ontario government passed Regulation 66/10 to the *Ontario Energy Board Act*, 1998.[3] This new regulation directs the Ontario Energy Board to assess a special levy on the Independent Electricity System Operator ("IESO") and distributors, assessed in proportion to the amount of electricity they distribute.[4] The levy is designed to deliver to the province $53.7 million in additional revenue, to fund activities of the Ministry of Energy and Infrastructure. In what follows, we ask whether it is more appropriate to characterize this levy as a tax, or as a regulatory fee, and explain why the characterization matters.

What is the Proper Characterization of the Levy?

From the perspective of the *Constitution Act, 1867*, taxes are either direct or indirect; in Canadian law, a direct tax is paid by the person on whom a charge is levied, and an indirect tax is passed on to others, as with most sales taxes.[5] Under subsection 92(2) of the Act, provinces have the jurisdiction to impose direct taxes but not indirect taxes.[6] Provinces have other "heads" of constitutional power that permit the imposition of fees, as discussed below, even if the fees look like they otherwise might be constitutionally invalid indirect taxes. In no case, however, does a province have a constitutional ability to impose a tax – direct or indirect – through regulation alone. Constitutionally valid taxation requires legislation.

A tax is distinguishable from a fee, according to the Supreme Court of Canada, on the basis that taxes are: "(1) enforceable by law; (2) imposed under the authority of the legislature; (3) levied by a public body; and (4) intended for a public purpose."[7] The most problematic of these criteria in this case is the second, since the levy is not clearly "imposed under the authority of the legislature." Before taking on the issue of whether the OEB special levy was validly introduced, we consider whether the other criteria are met. With respect to the first criterion, the new levy imposed by Ontario regulation 66/10 is legally compulsory. The distributors licensed under Part V of the *Ontario Energy Board Act*, 1998 are mandated to pay the amount determined by the OEB, as is the IESO. The third criterion states that to be a tax, the levy must be assessed by a public body. This is satisfied here as the levies are collected by the OEB for the Ministry of Energy and Infrastructure. The fourth criterion is more difficult to judge. Is the levy intended for a public purpose? On the one hand, the fee could be justified as a means of cost recovery with respect to delivering electricity from renewable sources. On the other hand, as there is nothing about the fee that closely connects it to the costs of the electricity that ratepayers consume, there is little to distinguish it from any other provincial taxing and spending program.

2 On the permissibility of this, see *Canadian Taxpayers Federation v Ontario (Minister of Finance)*, (2004) 73 O.R. (3d) 621; [2004] O.T.C. 1115; 135 A.C.W.S. (3d) 1041 (Ont. Sup. Ct. J.).

3 "ONTARIO REGULATION 66/10, Assessments for Ministry of Energy and Infrastructure Conservation and Renewable Energy Program Costs," available at http://www.e-laws.gov.on.ca/html/regs/english/elaws_regs_100066_e.htm. A provincial Order-in-Council (a regulation) is a formal recommendation of Cabinet that is signed into force by the Lieutenant-Governor.

4 The Ontario Energy Board (OEB) is responsible for regulating electricity and natural gas transmission, distribution and sale within the province. The IESO is responsible for operating the wholesale electricity market and managing financial settlements within it.

5 This is a legal distinction; the economic distinction between a direct tax on persons and an indirect one collected by intermediaries is irrelevant to the matters raised here.

6 Provinces are able to levy sales taxes by, for example, designating retailers as tax collectors on behalf of the province.

7 *Lawson v Interior Tree Fruit and Vegetable Committee of Direction*, [1931] S.C.R. 357, at pp. 362-63, cited with approval in *Re Eurig Estate*, [1998] 2 S.C.R. 565, and *Westbank First Nation v British Columbia Hydro and Power Authority*, [1999] 3 S.C.R. 134.

The Supreme Court of Canada has endorsed the view that "a nexus must exist between the quantum charged and the cost of the service provided in order for a levy to be considered constitutionally valid. [...] In determining whether that nexus exists, courts will not insist that fees correspond precisely to the cost of the relevant service. As long as a reasonable connection is shown between the cost of the service provided and the amount charged, that will suffice."[8]

The Ontario Government is clearly of the view that the levy is a fee and therefore legal. The strongest argument in support of the view that the levy is a valid regulatory fee, not a tax, is that it is limited to a set amount ($53.7 million), which was presumably selected to allow for cost recovery but not more than that. Moreover, the fee is allocated proportionally to the end-use of electricity. This leaves slightly unsettled the question of whether the levy is truly a fee for the use of electricity, or whether it is a mandatory tax supporting more or less unrelated program spending.

To reiterate, the relevant legal principles in assessing this question further are as follows:

- Subsection 92(2) of the *Constitution Act, 1867* explicitly allocates to provinces the power to impose direct taxes within the province.
- However, the Supreme Court of Canada has held that this power of direct taxation must be exercised through legislation on the authority of section 53 of the same Act. According to the Supreme Court of Canada, "The basic purpose of s. 53 is to constitutionalize the principle that taxation powers cannot arise incidentally in delegated legislation. In so doing, it ensures parliamentary control over, and accountability for, taxation."[9]

According to the Ontario regulation, the levy is in respect of "the expenses incurred and expenditures made by the Ministry in respect of its energy conservation programs or renewable energy programs."[10] As such, the proceeds are to be used to fund Ontario Ministry of Energy and Infrastructure energy conservation programs and renewable energy programs.

The Ontario Energy Board's Mandate

The OEB is a provincial agency, whose mandate focuses on regulating and setting rates for electricity and gas distribution. Rate setting responsibilities do not generally include raising money for other government programs. With respect to electricity, the *Ontario Energy Board Act, 1998* describes the mandate and objectives of the board in subsection 1(1) (see Box 1).

Box 1: The Ontario Energy Board's Objectives With Respect to Electricity Regulation

The Board, in carrying out its responsibilities under this or any other Act in relation to electricity, shall be guided by the following objectives:

1. to protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service;
2. to promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry;
3. to promote electricity conservation and demand management in a manner consistent with the policies of the Government of Ontario, including having regard to the consumer's economic circumstances;
4. to facilitate the implementation of a smart grid in Ontario;
5. to promote the use and generation of electricity from renewable energy sources in a manner consistent with the policies of the Government of Ontario, including the timely expansion or reinforcement of transmission systems and distribution systems to accommodate the connection of renewable energy generation facilities.

8 *Re Eurig Estate, ibid.*

9 *Ibid.*

10 Ontario Regulation 66/10, "Assessments for Ministry of Energy and Infrastructure Conservation and Renewable Energy Program Costs," section 3.

It is relevant that subsection 26(8) of the *Ontario Energy Board Act* grants the power to the Lieutenant Governor in Council to make regulations, "governing assessments" under section 26.1. Specifically, subsection 26.1(1) states that, "the Board shall assess [...] as prescribed by regulation, with respect to the expenses incurred and expenditures made by the Ministry of Energy and Infrastructure in respect of its energy conservation programs or renewable energy programs provided under this Act, the *Green Energy Act, 2009*, the *Ministry of Energy and Infrastructure Act* or any other Act." Subsection 26.2(1) builds on the delegation of authority by deeming all amounts collected under section 26.1 to be collected for certain special purposes set out in subsection 26.2(2).

Whether this delegation of taxing authority is legally permissible is unclear for two reasons. The first is that it is likely that a court could perceive the levy to be an indirect tax. It is collected from distributors in proportion to their electricity sales in support of other government spending, quite independently of the cost of goods or services sold or the costs of running the regulatory agency. As an indirect tax, it would not be within the province's legal authority to enact, even if it were legislated. The second reason is that, assuming for the sake of argument that it is not an indirect tax, it is doubtful that this sort of delegation of taxing authority through regulation would be constitutionally permissible. Could the federal government, for example, delegate the ability to adjust the rate of the Goods and Services Tax (GST) by regulation? The answer is almost certainly not, and for good reason.

Why these Questions Matter

On its face, the levy is a tax. Certainly most economists would deem it an indirect tax, and the case law suggests that this is also true in the legal sense. Given that the OEB levy is at the very least flirting with unconstitutionality, consider the incentives facing governments deciding whether to collect this $53.7 million through regulation versus legislation. On the one hand, raising revenues through regulation is relatively easy to achieve quietly and quickly. If a levy is indeed valid as a regulatory fee or user fee, then imposing it through regulation would be acceptable. In the event of a successful constitutional challenge that showed the levy to be a tax, however, the province would be under a legal obligation to return the revenues.[11]

The obligation to return the revenues is not unconditional, however. The law is also clear that retroactive taxes can be used to save the province from having to disgorge the revenues.[12] In the wake of the Supreme Court of Canada's judgment in 2007 that New Brunswick would have to return unconstitutionally collected indirect taxes on liquor sales, the province passed a retroactive direct tax equal to the unconstitutional indirect tax. In that case, the province performed legal manipulations that designated intermediate payers as agents of the government for the purpose of collecting a curative and retroactive direct tax.

Concluding Comments

Provided the political will is available, the government has the constitutional capacity to get its revenue one way or the other. The practical issue is the reaction of the electorate to a tax hike. Under its current plan, the Ontario government will get its revenue efficiently with a minimum of debate. On the other hand, if the regulation is subject to a successful constitutional challenge, the province will need to either return the funding, or carry on with the tax collection by way of retroactive legislation. That, however, may prove awkward, because the government would then have to explicitly override *Ontario's Taxpayer Protection Act, 1999*, which would require a referendum before any new taxes were imposed or increased.[13] In practice, the government would likely need to pass an amendment to the 1999 Act exempting the tax from the referendum requirement.

11 *Kingstreet Investments Ltd. v New Brunswick (Finance)*, [2007] 1 S.C.R. 3.

12 See Benjamin Alarie, "Kingstreet Investments: Taking a Pass on the Defence of Passing On," 2008, 46(1) *Canadian Business Law Journal* 36.

13 The *Taxpayer Protection Act 1999* also includes language that seems to prohibit the delegation discussed here: "3. (1) A member of the Executive Council shall not include in a bill a provision that gives a person or body (other than the Crown) the authority to change a tax rate in a designated tax statute or to levy a new tax unless, (a) a referendum concerning the authority that is to be given to the person or body is held under this Act before the bill is introduced in the Assembly; and (b) the referendum authorizes the authority to be given to the person or body."

If this does not happen, and a successful challenge is mounted at a time when considerable revenues have been collected, the provincial legislature will then be faced with the choice of making large payments to electricity distributors by way of restitution, with prejudgment interest, or attempting to pass a bill that legitimizes the status quo. The responses subsequent to the decision in *Re Eurig Estate*, where Ontario retroactively saved its unconstitutional probate tax, and *Kingstreet Investments*, where New Brunswick retroactively saved its unconstitutional liquor licensee tax, imply the possibility of a no-win outcome for taxpayers.

Yet it is against the public interest for the government to impose taxation through regulation. Public disdain for taxes that present themselves as regulatory fees may persuade the Ontario government to change course in this instance. Political pressure can shape government action and, in some circumstances, restrain governments from taking arbitrary actions. Taxation through regulation is taxation without representation. Should the Ontario government wish to avoid the possibility of a constitutional challenge, it should endorse Regulation 66/10 through explicit tax legislation.

This *e-brief* is a publication of the C.D. Howe Institute.

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